Banking and Monetary Developments in the Third Quarter of 1967

Credit demands in the economy were very strong in the third quarter of the year, when massive Treasury borrowing was added to the increased needs of private borrowers. Bank credit remained readily available and expanded over the quarter at an exceptionally fast pace. Despite this expansion, overall credit demands continued to press against supply, and interest rates rose considerably further.

The third-quarter banking expansion reflected the important role of commercial banks in financing the sharply higher Treasury borrowing requirements. Of the seasonally adjusted $14.4 billion expansion of bank loans and investments over the period, almost half was accounted for by bank acquisitions of United States Government securities and bank financing of the enlarged positions of Government securities dealers. Business loans at banks increased at only half the rate of the first six months of the year, but the total of all other loans expanded more strongly than in the first half year.

The heavy credit flows of the third quarter were associated with a substantial increase in the outstanding volume of liquid financial instruments. Treasury borrowing was primarily short term, adding to the liquid holdings of commercial banks and the nonbank public. Financial intermediation was again strong, giving rise to substantial further increases in liquid deposit claims against commercial banks, savings and loan associations, and mutual savings banks.

BANK CREDIT AND LIQUIDITY

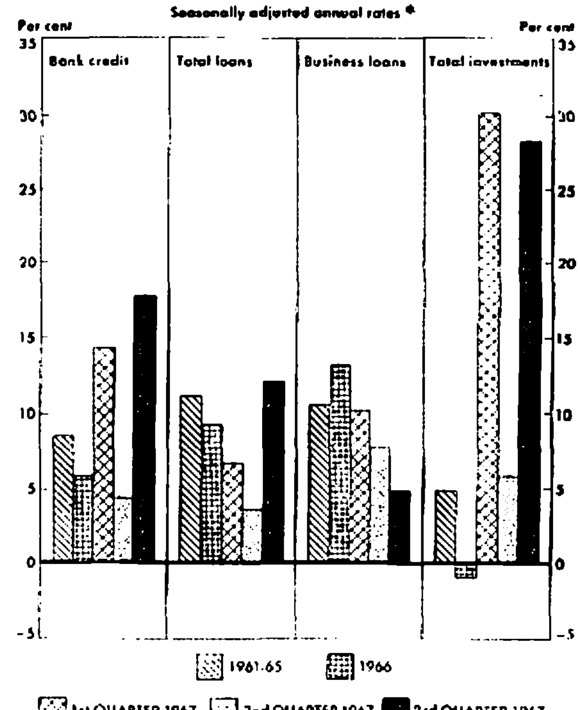
Unusually strong overall financing demands in the economy, coupled with continued comfortable bank reserve positions, gave rise to a sharp expansion of commercial bank loans and investments during the third quarter of 1967 (see Chart I). Total loans and investments of all commercial banks advanced at a 17¾ per cent seasonally adjusted annual rate over the quarter, up very strongly from the 4½ per cent rate of growth in the previous three months. The major portion of bank credit growth during the third quarter was concentrated in holdings of securities, especially of United States Government obligations.

Holdings of Government securities expanded $5.8 billion, accounting for about 40 per cent of the total increase in bank credit. All the third-quarter gain in holdings of Treasury obligations occurred in July and August, as banks acquired substantial amounts of tax anticipation bills—payable with full Tax and Loan Account credit—as well as a large volume of additional Treasury securities in the mid-August refunding and the late-August sale of new 3½-year Treasury notes. In September, holdings of Gov-

Chart I

PERCENTAGE CHANGES IN BANK CREDIT AND COMPONENTS AT ALL COMMERCIAL BANKS

Seasonally adjusted annual rates *



* Changes are computed from last-Wednesday-of-the-month figures.

Source: Board of Governors of the Federal Reserve System ernment securities fell by $0.2 billion at all commercial banks, a typical development in periods immediately following major Treasury financings. At such times, some banks begin redistributing a part of their recently acquired securities.

In the third quarter, the rate at which other than United States Government securities were acquired moderated somewhat from the unusually rapid pace of the first six months. While some banks appeared to be interested in attractively priced participation certificates and selected intermediate-term municipal obligations, the ability to obtain relatively high yielding and more liquid short-term Treasury issues apparently contributed to dampening interest in tax-exempt securities.

Total bank loans outstanding grew at a seasonally adjusted annual rate of 12¼ per cent in the third quarter, up strongly from a 3½ per cent increase in the second quarter. However, the rate at which business loans increased—about 5 per cent—was only half the pace of the previous six months and little more than one third the rate of expansion in the third quarter of 1966. Reduced tax payments following the completion of the earlier acceleration of business tax payment schedules, coupled with record heavy borrowing by corporations in the bond market, apparently reduced business need for shorter term bank accommodation. Business demands for bank financing were noticeably lighter than usual over the mid-September tax and dividend payment date.

Bank loans other than business loans rose substantially faster in the third quarter than in the second quarter. Among the other loan categories, loans to securities brokers and dealers expanded very rapidly, in line with greatly increased Treasury financing activity. Real estate and consumer loans also advanced further over the third quarter, paralleling a continued advance in housing starts and retail sales, and agricultural loans picked up. On the other hand, outstanding bank loans to finance companies fell over the quarter, as these companies experienced some decline in the need for funds, due partly to reduced financing requirements of retail automobile dealers. At the same time, finance companies continued to find funds readily available in the commercial paper market. Although yields on ninety-day finance company paper rose from 4.40 per cent in June to 4.76 per cent at the end of September, these rates remained well below the prime lending rate at commercial banks.

Bank liquidity generally improved during the third quarter. For all commercial banks, the aggregate ratio of loans (excluding securities loans) to deposits fell 2.0 percentage points to 62.8 per cent. At New York City banks, where ratios had been much higher, the drop was somewhat less pronounced, from a June average of 76.2 per cent to 74.7 per cent in September. However, loan-deposit ratios at the end of September still remained high by recent standards.

MONEY SUPPLY, BANK DEPOSITS, AND RESERVES

Bank deposits and the money supply expanded during the third quarter at approximately the same rapid pace as in the second quarter (see Chart II). The seasonally adjusted money supply—currency outside banks and privately held demand deposits—rose $3.0 billion over the quarter, or at an annual rate of 7 per cent. The advance occurred mostly in July and August, and there was only a modest further rise in September. The September slowdown was probably partially related to the midmonth corporate tax payments, which resulted in a shift of funds from private demand deposits to public accounts. Government demand deposits increased strongly in September.

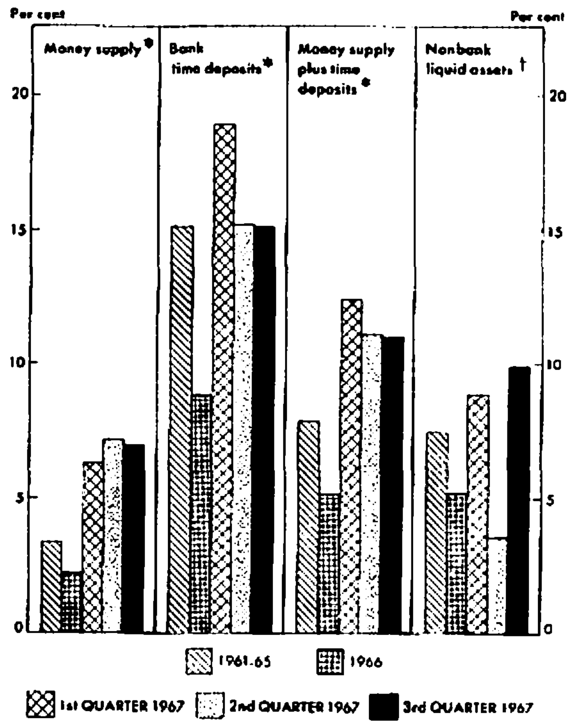
Total time and savings deposits at commercial banks also continued to expand rapidly in the third quarter, rising by $6.5 billion or at an annual rate of over 15 per cent. This brought the advance for the year through September to an annual rate of 17 per cent, roughly twice the rate of expansion in 1966 and above the strong average growth rate for 1961-65. Data from large weekly reporting commercial banks indicate that, over the third quarter, savings deposits grew at about the same moderate pace as in the first half of the year and other time deposits, excluding large negotiable certificates of deposit (C/D's), continued to post substantial advances. These developments indicate that commercial banks were able to compete effectively with rising yields on marketable securities and to maintain their competitive positions relative to other deposit-receiving institutions.

The volume of outstanding large C/D's increased slightly over the quarter. After remaining essentially unchanged from March through June, as large accelerated tax payments limited the ability of corporations to acquire such assets, C/D's began to increase sharply immediately after the June tax date. This increase reflected higher rates offered by banks as well as the improved liquidity positions of corporations. Posted offering rates on C/D's moved up in all maturity brackets, and in many cases banks were willing to pay more than their posted rates for large blocks of money. However, following a sharp expansion of C/D's in July and August, there was a substantial runoff in mid-September, when many corporations required funds for dividend and tax payments. On balance, for the quarter as a whole, total outstanding C/D's increased by $0.7 billion. In addition, commercial banks substantially increased their

Chart II

PERCENTAGE CHANGES IN LIQUIDITY INDICATORS

Seasonally adjusted annual rates



* Computed from daily averages for the months preceding and ending each period.

† Computed from levels at the beginning and end of each period.

Source: Board of Governors of the Federal Reserve System.

borrowings of Euro-dollars—foreign-owned dollar balances—during the third quarter.

Conditions in the money market remained generally comfortable during the third quarter. Nationwide free reserves averaged $282 million on a daily average basis during the quarter. Nonborrowed reserves increased at a rapid rate, and borrowings by member banks from the Federal Reserve fell to the lowest level since the third quarter of 1962. Total reserves rose substantially faster than required reserves, and excess reserves—the difference between total and required reserves—rose to their highest level since the first quarter of 1965.

NONBANK LIQUIDITY

Liquid assets held by the nonbank public increased at an annual rate of about 10 per cent during the third quarter, substantially above the rapid pace in the first half of 1967 (see Chart II). The major source of the faster gains of liquid assets was a sharp $2 billion rise of short-term United States Government securities held by the nonbank public, following a net decline of such holdings in both the first and second quarters. The growth of currency and demand deposits, as noted earlier, was 7 per cent, about the same as the rapid rate of the previous three months. Total personal-type time and savings accounts at commercial banks, savings and loan associations, and mutual savings banks rose at a rapid pace of nearly 12 per cent per annum, slightly above the gain of the preceding quarter. The substantially higher level of rates on marketable securities in the third quarter does not, therefore, seem to have adversely affected the deposit performance of either commercial banks or the nonbank savings institutions, even though interest rates offered on deposits appear to have remained essentially unchanged in the third quarter.[1] This suggests that the competitive position of banks and other deposit-issuing savings institutions may have undergone an improvement since 1966, when large amounts of deposits were shifted into open market investments at interest rates comparable to those recently prevailing.

Growth of deposits at nonbank thrift institutions expanded by 10½ per cent (seasonally adjusted annual rate), slightly faster than the 9½ per cent gain in the second quarter, and savings and loan associations and mutual savings banks were able not only to continue rebuilding their liquidity but also to increase their mortgage lending substantially. Mortgages held by these two types of institutions increased at an 8.0 per cent annual rate in the third quarter, extending the steady recovery of their mortgage lending that has been apparent since the fall of 1966.

[1] On September 21, President Johnson signed into law a one-year extension of the statute authorizing the regulatory authorities to set the interest rates financial institutions pay on deposits. In addition to extending existing ceilings on commercial banks (for details, see this *Review*, October 1966, page 221), the new law incorporates changes which became effective on July 1 in the maximum payments that could be made by mutual savings banks insured by the Federal Deposit Insurance Corporation (FDIC) and savings and loan associations affiliated with the Federal Home Loan Bank System (FHLBS). Thus, the current ceilings for these institutions are now (1) 5 per cent on all savings deposits in mutual savings banks insured with the FDIC and (2) 4¾ per cent maximum on all passbook savings in savings and loan associations in the FHLBS and up to 5¼ per cent on certificate accounts held for at least six months, with three major exceptions: (a) institutions paying more than 4¾ per cent prior to September 22, 1966 may pay up to 5 per cent on passbook savings and savings certificates, (b) institutions in California, Nevada, Alaska, and Hawaii may pay up to 5¼ per cent on certificates held for three years or more and 5¾ per cent on savings certificates if the funds were received prior to September 22, 1966, and (c) institutions in areas where the average interest rate on mutual savings bank deposits exceed 4¾ per cent may pay as high as 5 per cent on savings accounts.